

Generally, sales of "canned" computer software are taxable retail sales in Illinois regardless of the form in which the software is transferred. Therefore, sales of canned computer software over the Internet are taxable sales in Illinois. See 86 Ill. Adm. Code 130.1935. (This is a GIL).

March 23, 1999

Dear Mr. Xxxxx:

This letter is in response to your letter dated February 8, 1999. The nature of your letter and the information you have provided require that we respond with a General Information Letter, which is designed to provide general information, is not a statement of Department policy and is not binding on the Department. See 86 Ill. Adm. Code 1200.120(b) and (c), enclosed.

In your letter, you have stated and made inquiry as follows:

FIRM is requesting a letter ruling on behalf of our client COMPANY. With this request, COMPANY is seeking to obtain verification that the products and services rendered during certain phases of their operations are exempt from sales and use tax in the state of Illinois. Please see the attached diagram, which better illustrates the process.

FACTS

COMPANY, located in CITY/STATE, performs graphic arts services pertaining to the printing of catalogs. COMPANY's services are limited to pre-press activities in regard to these catalogs. COMPANY employs six sales people who travel throughout the United States. These sales people travel to client sites one to ten times a year and the sales process takes approximately six to eighteen months.

COMPANY initially provides an evaluation of a potential customer's needs at the customer's location in Illinois. The majority of COMPANY's services however, are performed in the state of STATE, where customer information is stored on computer servers located in CITY.

Analysis & Specification Phase

COMPANY performs a feasibility study for the client before the sale. One or two programmers and the Customer Service Manager ('CSM') travel to the potential customer's location in Illinois to ascertain the company's needs and determine how COMPANY can assist the customer. Reports are produced and forwarded to the customer detailing the information obtained during the feasibility study. This process is called the **Analysis & Specification** phase and a fee might be charged for this service.

'Step Three'

After the **Analysis & Specification** Phase has been completed and a contract has been signed, COMPANY customizes its proprietary software on its servers in CITY, at its own cost, to the specifications dictated by a particular customer. Although this software is licensed, it is never sold, but the customer may purchase communications software, at a nominal charge, which will allow access to COMPANY's database located in CITY/STATE. The customization of the proprietary software is called **'Step Three'**.

Database Population

After the customization of COMPANY's proprietary software is complete, COMPANY begins the process of **Database Population**. This process involves scanning images into the STATE based database from information provided by the customer. Once the images are scanned, the customer will proof the images either through physical media or through electronic media, such as a modem. Proofing will occur three to four times. Once proofing is complete, the customer will define the modules. Modules consist of a page layout showing what type of information will be placed on each page (text, pictures, tables, etc...).

Extraction

The last phase, performed in STATE, is called **Extraction**. This process includes final module editing and placing the data onto the customer's preferred medium in the form of a .pdf file. The customer may choose to have the .pdf file placed on diskette, CD-ROM, film, or on electronic media. The medium is then conveyed to either the customer or the customer's designee.

There is a substantial possibility that if the tangible personal property is conveyed to the customer's designee and not to the customer it may never enter the state of Illinois.

ISSUE

Are the products and services rendered in COMPANY's **Analysis & Specification**, **'Step Three'**, **Database Population**, and **Extraction** phases subject to sales and use tax in the state of Illinois?

DISCUSSION

The Illinois Administrative Code states that Illinois imposes the following taxes in the nature of sales and use taxes: [ILCS, Ch. 35 1202, ILCS, Ch. 35-153-10, ILCS, Ch. 35 1053]

- (a) Retailer's Occupation Taxes on retail sales of tangible personal property,

- (b) Service Occupation Tax on the transfer of tangible personal property incident to the sale of services, and
- (c) Use tax on the use, storage or other consumption of tangible personal property purchased at retail in the state.

The retailers' occupation tax is imposed on persons engaged in the business of making retail sales of *tangible personal property* to buyers for use or consumption. The Service Occupation Tax applies to persons engaged in the business of making *sales of service*. **Services, as such, are not taxable.** Service persons, however, are liable for the tax on tangible personal property transferred as an incident to their retail sale of services. The use tax is imposed on the privilege of using in the state any tangible personal property that is bought anywhere from a retailer.

It is FIRM's position that COMPANY's **Analysis & Specification** phase is not taxable. During this phase, COMPANY is merely performing a feasibility study for the potential client to determine whether this potential client can benefit from COMPANY's services. In accordance with the Illinois law stated above, the performance of a feasibility study is not taxable.

It is also FIRM's view that COMPANY's **"Step Three"** phase is also not subject to sales or use tax in the state of Illinois. During this phase, COMPANY is customizing its own software. According to the Illinois law, the charges for the customization of computer software are not subject to sales and use tax. The law explains that custom computer programs prepared to the special order of the customer are not subject to sales and use tax and certain elements must be present. The elements are (1) that customization requires an analysis of the customer's requirements by the vendor and (2) that the program requires adaptation by the vendor to be used in a specific work environment. [86 Ill. Adm. Code, Ch. 1 and § 130.1935]. Further, this customization is not performed in the state of Illinois but rather in COMPANY's home state, STATE and is never conveyed to the customer in Illinois.

Finally, FIRM believes that COMPANY's **Database Population** and **Extraction** phases are not subject to sales and use tax. During these phases, COMPANY is ultimately performing 'graphic arts' services. Illinois has defined services such as those performed by COMPANY as 'graphic arts' services. Included in the definition of graphic arts services are 'print trade services' such as typesetting, negative production, plate production, bookbinding, finishing, and loose-leaf binder production are examples of services which are included in the definition of graphic arts production. [86 Ill. Adm. Code §130.325(b)].

Furthermore, in a private letter ruling, the Department of Revenue held that a photo-engraving company providing services including art

work, typesetting, color separating and computer design work with printing plates as the final product was in fact providing graphic arts services. [Ill. DOR General Information Letters ST 98-0041-GIL, (1998)].

After the **Extraction phase**, COMPANY ultimately transfers their revised modules to either its customer in the state of Illinois, or to a printer in Illinois or another state. Although tangible personal property is transferred in the extraction phase, the tangible personal property is merely incidental to the sale and may never enter Illinois. Accordingly, the Department has held that tangible personal property transferred incident to the sale of a service is not subject to the Service Occupation Tax, but will be subject to the Retailers' Occupation Tax. In the case of COMPANY, the charge for the CD-ROM or the film itself, not the services performed to create them are subject to sales tax.

We respectfully request, a letter ruling from the Illinois Department of Revenue stating that the products, services and the incidental transfer of tangible personal property conveyed in the performance of these services rendered by COMPANY in the above phases are not subject to taxation in Illinois and stating the nature of the exemption from sales and use tax.

Enclosed, please find a copy of 86 Ill. Adm. Code 130.1935 regarding computer software. This regulation states, in part, as follows:

Computer software means all types of software including operational, applicational, utilities, compilers, templates, shells and all other forms. Canned software is considered to tangible personal property **regardless of the form in which it is transferred or transmitted, including tape, disc, card, electronic means or other media.** The sale at retail, or transfer, of canned software intended for general or repeated use is taxable, including the transfer by a retailer of software which is subject to manufacturer licenses restricting the use or reproduction of the software. (Emphasis added).

Generally, sales of "canned" computer software are taxable retail sales in Illinois regardless of the form in which the software is transferred. Therefore, sales of canned computer software over the Internet are taxable sales in Illinois. See the enclosed copy of 86 Ill. Adm. Code 130.1935. However, if the computer software consists of custom computer programs, then the sales of such software may not be taxable retail sales. See Section 130.1935(c).

Custom computer programs or software are prepared to the special order of the customer. The selection of pre-written or canned programs assembled by vendors into software packages does not constitute custom software unless real and substantial changes are made to the programs or creation of program interfacing logic. See Section 130.1935(c)(3).

If transactions for the licensing of computer software meet all of the criteria provided in Section 130.1935(a)(1), neither the transfer of the software or the subsequent software updates will be subject to Retailers' Occupation Tax.

A license of software is not a taxable retail sale if:

- A) It is evidenced by a written agreement signed by the licensor and the customer;
- B) It restricts the customer's duplication and use of the software;
- C) It prohibits the customer from licensing, sublicensing or transferring the software to a third party (except to a related party);
- D) The vendor will provide another copy at minimal or no charge if the customer loses or damages the software; and
- E) The customer must destroy or return all copies of the software to the vendor at the end of the license period.

As stated above, licenses of computer software are not taxable if they meet all of the criteria listed in Section 130.1935(a)(1). However, item (D) of that part requires the license to contain a provision requiring the vendor to provide another copy at minimal or no charge if the customer loses or damages the software. The Department has deemed software license agreements to have met this criteria if the agreements do not contain a provision about the loss or damage of the software, but the vendors' records reflect that they have a policy of providing copies of software at minimal or no cost if the customers lose or destroy the software.

Item (E) of this part also requires a license to require a customer to destroy or return all copies of the software to the vendor at the end of the license period. The Department has also deemed a perpetual license agreement to qualify for this criterion even though no provision is included in the agreements that require the return or the destruction of the software.

Retailers' Occupation Tax and Use Tax do not apply to receipts from sales of personal services. Under the Service Occupation Tax Act, servicemen are taxed on tangible personal property transferred incident to sales of service. For your general information we are enclosing a copy of 86 Ill. Adm. Code 140.101 regarding sales of service and Service Occupation Tax.

The purchase of tangible personal property that is transferred to service customers may result in either Service Occupation Tax liability or Use Tax liability for the servicemen, depending upon which tax base the servicemen choose to calculate their liability. Servicemen may calculate their tax base in one of four ways: (1) separately stated selling price; (2) 50% of the entire bill; (3) Service Occupation Tax on cost price if they are registered de minimis servicemen; or, (4) Use Tax on cost price if the servicemen are de minimis and are not otherwise required to be registered under the Retailers' Occupation Tax Act.

Using the first method, servicemen may separately state the selling price of each item transferred as a result of sales of service. The tax is based on the separately stated selling price of the tangible personal property transferred. If servicemen do not wish to separately state the selling price of the tangible personal property transferred, those servicemen must use 50% of the entire bill to their service customers as the tax base. Both of the above methods provide that in no event may the tax base be less than the cost price of the tangible personal property transferred. Under these methods, servicemen may provide their suppliers with Certificates of Resale when purchasing the tangible personal property to be transferred as a part of the sales of service.

The third way servicemen may account for their tax liability only applies to de minimis servicemen who have either chosen to be registered or are required to be registered because they incur Retailers' Occupation Tax liability with respect to a portion of their business. Servicemen may qualify as de minimis if they determine that their annual aggregate cost price of tangible personal property transferred incident to sales of service is less than 35% of their annual gross receipts from service transactions (75% in the case of pharmacists and persons engaged in graphic arts production). See, 86 Ill. Adm. Code 140.101(f) enclosed. This class of registered de minimis servicemen is authorized to pay Service Occupation Tax (which includes local taxes) based upon the cost price of tangible personal property transferred incident to sales of service. They remit the tax to the Department by filing returns and do not pay tax to suppliers. They provide suppliers with Certificates of Resale for the property transferred to service customers.

The final method of determining tax liability may be used by de minimis servicemen that are not otherwise required to be registered under the Retailers' Occupation Tax Act. Servicemen may qualify as de minimis if they determine that their annual aggregate cost price of tangible personal property transferred incident to sales of service is less than 35% of their annual gross receipts from service transactions (75% in the case of pharmacists and persons engaged in graphic arts production). Such de minimis servicemen may pay Use Tax to their suppliers or may self-assess and remit Use Tax to the Department when making purchases from unregistered out-of-State suppliers. Those servicemen are not authorized to collect "tax" from their service customers, nor are they liable for Service Occupation Tax. It should be noted that servicemen no longer have the option of determining whether they are de minimis using a transaction by transaction basis.

An "Illinois Retailer" is one who either accepts purchase orders in the State of Illinois or maintains an inventory in Illinois and fills Illinois orders from that inventory. The Illinois Retailer is then liable for Retailers' Occupation Tax on gross receipts from sales and must collect the corresponding Use Tax incurred by the purchasers.

Another type of retailer is the retailer maintaining a place of business in Illinois. The definition of a "retailer maintaining a place of business in Illinois" is described in 86 Ill. Adm. Code 150.201(i), enclosed. This type of retailer is required to register with the State as an Illinois Use Tax collector. See 86 Ill. Adm. Code 150.801, enclosed. The retailer must collect and remit Use Tax to the State on behalf of the retailer's Illinois customers even though the

retailer does not incur any Retailers' Occupation Tax liability.

The United States Supreme Court in Quill Corp. v. North Dakota, 112 S.Ct 1904 (1992), set forth the current guidelines for determining what nexus requirements must be met before a person is properly subject to a state's tax laws. The Supreme Court has set out a 2-prong test for nexus. The first prong is whether the Due Process Cause is satisfied. Due process will be satisfied if the person or entity purposely avails itself or himself of the benefits of an economic market in a forum state. Quill at 1910.

The second prong of the Supreme Court's nexus test requires that, if due process requirements have been satisfied, the person or entity must have physical presence in the forum state to satisfy the Commerce Clause. A physical presence is not limited to an office or other physical building. Under Illinois law, it also includes the presence of any agent or representative of the seller.

The final type of retailer is the out-of-State retailer that does not have sufficient nexus with Illinois to be required to submit to Illinois tax laws. A retailer in this situation does not incur Retailers' Occupation Tax on sales into Illinois and is not required to collect Use Tax on behalf of its Illinois customers. However, the retailer's Illinois customers will still incur Use Tax on the purchase of the out-of-State goods and have a duty to self-assess their Use Tax liability and remit the amount directly to the State. The Use Tax rate is 6.25%.

I hope this information is helpful. The Department of Revenue maintains a Web site, which can be accessed at www.revenue.state.il.us. If you have further questions related to the Illinois sales tax laws, please contact the Department's Taxpayer Information Division at (217) 782-3336.

If you are not under audit and you wish to obtain a binding Private Letter Ruling regarding your factual situation, please submit all of the information set out in items 1 through 8 of the enclosed copy of Section 1200.110(b).

Very truly yours,

Melanie A. Jarvis
Associate Counsel

MAJ:msk
Enc.